Office of Financial Management

Internal Control Evaluation – Soft Controls
Self –Study

OVERVIEW

This self-study will be useful to personnel desiring to increase their understanding of State of Michigan internal control evaluation practices. This self-study provides concepts of soft controls, hard controls and CSA, a common tool used to assess business processes and promote effectiveness within an organization. At the end of this self-study, take the test and submit it to DMB-Office of Financial Management to receive 1 hour of CPE.

The concept of soft controls is not new to the evaluation of internal controls in State operations. The 1990 version of the State's General Framework discusses employees, from management on down, their ethical values, competency, and how they shape the achievement of stated objectives.

Soft controls have been a part of COSO (Committee of Sponsoring Organizations of the Treadway Commission) terminology since the COSO report was issued in 1992. However, it was not until the last few years that soft controls have come to the forefront primarily because management and auditors were focused on hard controls, and there was a lack of understanding of the concept of soft controls. Recently, the body of knowledge and related evaluation tools that have come out of numerous COSO implementation success stories have helped bridge the gap and allowed for greater understanding.

In 1999, the State of Michigan adopted a framework to comply with provisions of the Management and Budget Act. The new State of Michigan framework is based upon the COSO. COSO is a widely accepted internal control framework emphasizing that the system of internal controls in any organization is intended to provide reasonable assurance regarding:

- Achievement of objectives related to effective/efficient operations
- Reliable financial reporting
- Compliance with statutes, rules and regulations

1

Internal Control Evaluation
Soft Controls – Self Study

Soft controls focus on ethics, integrity, competency, relationship building (internally and externally), etc. Hard controls deal more with the tangible –existence of policies and procedures, proper document/payment approval, segregation of duties, etc. Where hard controls deal with whether you have policies and procedures in place for ethics, the soft controls deal with how management knows that employees are adhering to the entity's policy on ethics.

The COSO report, *Internal Control – Integrated Framework* has established and defined an overall framework and philosophy that organizations can use to manage risks and achieve objectives. This document clearly indicates that the key to organizational effectiveness goes beyond the tangible, measurable controls that have been the traditional purview of internal auditors. This document emphasizes the importance of "soft" or "behavioral" controls, like trust and effective leadership that have been considered difficult to evaluate.

Control Environment (Organizational Culture)

The control environment establishes the foundation for the internal control system by providing fundamental discipline and structure. An effective control environment is an environment where competent people understand their responsibilities, the limits to their authority, and are knowledgeable, mindful, and committed to doing what is right. They are committed to following an organization's policies and procedures and its ethical and behavioral standards. The control environment encompasses technical competence and ethical commitment. It is an intangible factor essential to effective internal control.

A governing board and management enhance an organization's internal control environment when they establish and effectively communicate written policies and procedures, a code of ethics, and standards of conduct.

Effective human resource policies and procedures enhance an organization's control environment. These policies and procedures address hiring, orientation, training, evaluations, counseling, promotions, compensation, and disciplinary actions. In the event that an employee or manager doesn't comply with an organization's policies and procedures or behavioral standards, an organization must take appropriate disciplinary action to maintain an effective control environment. The control environment is greatly influenced by the extent to which individuals recognize that they will be held accountable.

From the COSO Report
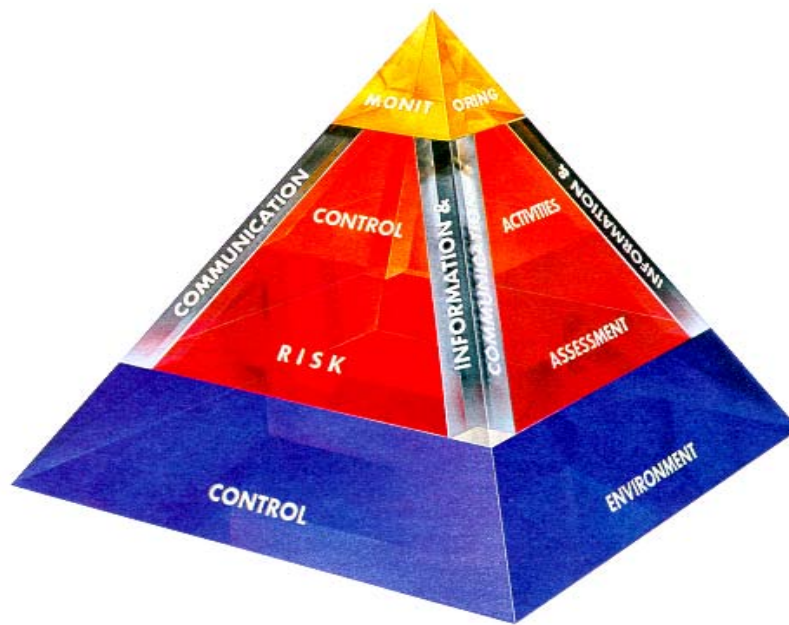
The control environment consists of soft and hard controls. The COSO model defines five interrelated control components: control environment, risk assessment, control activities, information and communication, and monitoring.   The foundation upon which these components rest is the control environment, which includes behavioral controls such as integrity, ethical values, competence of employees and management; management's philosophy and operating style; management's method of assigning authority and responsibility, organizing and developing its people; attention and direction.

HARD AND SOFT CONTROLS

Hard controls are controls over systems, processes, and/or procedures, that when applied correctly, demonstrate that a specific organization policy or procedure is being adhered to. Examples of hard controls:

- Requiring employees to sign-off a distribution sheet indicating they have read the entity's code of conduct.

- Requiring employees to place in their personnel file evidence of receiving certain amount of training in specific area.

- Documented approval by a specified responsible party.

- Double signatures by responsible parties for disbursement checks above specific dollar amount.

- Requiring matching of documents, before paying a vendor invoice.

With COSO's emphasis on employee and managerial behavior, soft controls and soft controls testing, take on a greater significance for internal and external auditors. Examples of soft controls:

- **Knowledge and competence performance standards** used for hiring and promotion.

- Performance standards distributed to employees for **appropriate ethical behavior.**

- Employees and managers periodically tested to determine **awareness** of environmental risks and related safety procedures.

- Education and training **competencies** established for all employees and managers.

- Feedback from personnel to determine if they are adapting to **changing operating conditions.**

- **Feedback** from customers, suppliers, and other outside parties to determine if employees and managers are adhering to policies and procedures.

A Working Inventory of Soft Controls

CONTROL ENVIRONMENT

Integrity and Ethical Values

- Policy statements (codes of conduct, conflicts of interest, standards of ethical and moral behavior, etc.) exist, are meaningful, and are implemented.

- Management formally and informally communicates the organization's values.

- Management's behavior exemplifies the organization's values.

- Employees understand values, behave accordingly, and know what to do if they encounter improper behavior.

- Employees are given ongoing feedback regarding appropriate actions and behaviors.

- Performance targets are realistic; employees are not unduly pressured to meet targets.

- Management deals appropriately with problems, especially when the cost of identifying problems and dealing with the issues could be large.

- Corrective action is taken as a result of departures from approved policies/procedures, to include reinforcement/retraining in proper policies/procedures.

- Management has created a "perception of detection" by appropriate policies, informal communication, and responding appropriately to violations of behavioral standards.

- Exceptions to policy are allowed only under clearly defined conditions. When they occur, they are documented, explained, and reviewed.

- Everyday dealings with customers, vendors/contractors, employees and other parties are based on honesty and fairness.

Commitment to Competence

- Job descriptions are formal or informal, depending on the environment.

- Employees understand their job descriptions.

- Employees have requisite knowledge, skills, and experience.

- Employees are committed to excellence in performing their jobs.

- The organization and its employees are committed to continuous improvement.

Management's Philosophy and Operating Style

- Management understands its responsibility.

- Manger's operating style supports the organization's values and desired culture.

- Managers proactively communicate the organization's values.

- Managers have high expectations of employee performance.

- Management fosters pride in the organization, its work, and its achievements.

- Management fosters teamwork and an atmosphere of mutual trust.

- Management fosters open communication (e.g., encourages employee suggestions and concerns, and responds appropriately).

- Management interacts sufficiently with lower levels, to maintain open communication and leads by example.

- Management frequently interacts with geographically disbursed personnel and operations.

- Management understands controls and their significance to reporting.

- Management is not obsessively focused on short-term results.

Organizational Structure

- The structure is appropriately centralized or decentralized, given the nature of the program area's operations.

- The structure is flexible enough to permit changes when operating plans, policies, or objectives change.

- The structure facilitates flow of information upwards, downwards, and across organizational lines.

- Reporting relationships are appropriate and effective.

Assignment of Authority and Responsibility

- Accountability is clearly defined and communicated.

- Authority is commensurate with responsibility.

- Responsibilities are clearly communicated and understood.

- Managers and supervisors have sufficient time and resources to carry out their responsibilities effectively.

- Managers and supervisors who assign responsibility and delegate authority to subordinates have an effective system of follow-up for making sure that tasks assigned are properly carried out.

Human Resource (HR) Policies and Practices

- HR office requests, classifies and evaluates positions by using acceptable evaluation techniques and is responsible for recruiting and testing applicants. Supervisors interview and assist in selecting new hires.

- HR policies and procedures are in place and reflect concern for control.

- Appropriate action is taken in response to improper behavior by employees.

- Performance appraisals provide frank and constructive discussion of performance issues.

- There is adequate communication between HR office and user department.

INFORMATION AND COMMUNICATION

- Information system development plans are consistent with entity-wide and activity-level objectives and plans.

- Relevant, useful, and timely information is provided.

- Employee suggestions, complaints, and other input are communicated to relevant internal parties, in a timely manner.

- Employees' duties and responsibilities are communicated to them.

- Communications across the organization, and with external parties, are open and effective.

- Customer complaints are communicated to appropriate levels of management and responded to appropriately.

Control Self Assessment (CSA)

Control self-assessment (CSA) is a powerful governance tool that helps auditors, management, and others improve their work functions to examine and assess business processes and promote effectiveness within the organization. CSA's basic philosophy is that control is the responsibility of all employees. The people who work within the process, i.e., employees as well as managers are asked for their assessment of risks and controls.

There are several definitions of CSA. In the IIA's first major publication about CSA, the term was defined as follows:

Organizations that use self-assessment have a formal documented process in which management and/or work teams directly involved in a business function:

- *judge effectiveness of the process in place and*
- *decide if chances of reaching some or all business objectives are reasonably assured.*

Jordan, Glenda S., Control Self-Assessment: Making the Choice (Altamonte Springs, Florida: The Institute of Internal Auditors), 1995,p1

In 1998, the IIA published the following definition:

CSA is a process through which internal control effectiveness is examined and assessed. The objective is to provide reasonable assurance that all business objectives will be met.

Professional Practices Pamphlet 98-2, A Perspective on Control Self-Assessment (Altamonte Springs, Florida: The Institute of internal Auditors), 1998, CSA definition chapter.

CSA differs from other auditing techniques in the following ways:

- Facilitated workshops are utilized.
- "Process owners" – management and staff (not internal auditors) evaluate internal controls.
- Work team members use anonymous voting technology to reduce the possibility of management influence.
- Work teams assess risks and internal controls.
- Workshops are used to teach risk assessment and internal control design to work teams.
- Management is more involved.
- The client instead of the auditor, issues reports.

Some of these techniques could be done by traditional audits. Process owners evaluating internal controls and work teams assessing risks and internal controls, without involvement of internal auditing, are truly unique to CSA. Some audit groups practicing CSA take different approaches to these issues.

Traditional auditing as compared to CSA:

Traditional Auditing	CSA Facilitation Work Team
Assesses risks and controls	Assesses risks and controls
Performs test of controls	Reviews Controls
Makes recommendations	Makes recommendations
Issues reports	Issues reports
Does not teach control design and methodology to clients	Learns control design and methodology

CSA brings a shift in certain responsibilities relating to internal controls:

Responsibilities	Traditional Approach	CSA Approach
Setting business objectives	Management	Management
Assessing risks	Management	Management
Determining adequacy of internal controls	Management	Management
Evaluating risk and controls	Auditors	Work teams
Reporting	Auditors	Work teams
Validating evaluation of risks and controls	Auditors	Auditors

Responsibility for evaluation of risk and controls changes with CSA from the auditor, to the work team performing the work.

Internal and external auditors agree that internal controls are the responsibility of management. The internal auditor is a facilitator to guide management and staff in the assessment process.

Benefits CSA brings to an organization are numerous, from both a management and internal audit perspective.

Management and Organizational Benefits

- Improves understanding of internal controls
- Improves internal controls
- Increases control consciousness
- Provides better understanding of business processes
- Benefits group dynamics
- Ensures management's commitment to improving controls
- Ensures management "sign off" on process objectives, controls and risks
- Allows the "experts" (process owners) to identify and evaluate issues
- Allows keeping pace with changes taking place
- Links functional controls and corporate governance
- Enables anticipation of potential risks
- Improves control environment
- Encourages employees to design, implement and continuously improve controls

Internal Audit Benefits

- Provides a better utilization of internal audit resources
- Builds relationships with management
- Better able to keep pace with rapidly changing environments
- Prioritizes audit action plans
- Increases knowledge of the organization
- Changes the image of internal audit
- Increases audit efficiencies; less fieldwork; better focus
- Improves audit-planning process
- Enables assessment of soft controls
- Allows management's input into audit plan
- Provides a better understanding of business processes

CSA Approach

Approaches to use in implementing CSA follow:

- Workshops
  Facilitated team meetings of management and "key players" involved in the business process from various parts of the organization.

- Questionnaires/Surveys
  Collect management's comments regarding the organization control structure via questionnaires and surveys. Standardized questions are designed to reveal the root cause of problems identified with the business process.

- Risk/Control matrix

Reporting

Traditionally, reporting on controls is done in an audit report; in CSA, it may be done in a report from the CSA workshop that goes to the next level of management above those assessing the controls.

In CSA, when reporting is done by work teams, controls clearly belong to management and the work teams, like their other objectives, goals, and responsibilities.

Recommended Reading

Evaluation of Internal Controls - A General Framework and System of Reporting – Pages 10 thru 17; Pages 34-39

Internal Control — Integrated Framework
Sponsored by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and researched and written by Coopers & Lybrand L.L.P.

Office of Financial Management

Internal Control Evaluation – Soft Controls
Self –Study
MULTIPLE-CHOICE QUESTIONS

This section is designed to assess understanding of soft controls as well as internal controls in general. Questions are designed to cover not only the materials presented in this study course but also covered in documents it linked to.
In order to receive one hour of CPE, complete following questions and submit to:

DMB - Office of Financial Management
Technical, Audit, and Business Services Division
Romney Building, 7th Floor
Lansing, MI 48909

Select a single answer, which **best** completes the statement or answers the question.

1. Which of the following best describes the interrelated components of internal control?
   a. Organizational structure, management philosophy, and planning.
   b. Control environment, risk assessment, control activities, information and communication systems, and monitoring.
   c. Risk assessment, backup facilities, responsibility accounting, and natural laws.
   d. Legal environment, management philosophy, and organizational structure.

2. Where does the primary responsibility for establishing and maintaining internal control rest?
   a. External auditor
   b. Management
   c. Controller
   d. Treasurer

3. "The process of working with and through others to achieve organizational objectives in a changing environment" is a good definition of:
   a. Referent power
   b. Management
   c. Informal leadership
   d. Motivation

4. Management of an organization is constantly influenced by external forces while carrying out its responsibilities. These forces are best described as:
   a. Strategic plans
   b. Corporate goals
   c. Effectiveness versus efficiency
   d. Changing environment

5. Which of the following best describes the concept of control as recognized by the internal auditor?
   a. Management regularly discharges personnel who do not perform up to expectations.
   b. Management takes action to enhance the likelihood that established goals and objectives will be achieved.
   c. Control represents specific procedures that accountants and auditors design to ensure correctness of processing.
   d. Control procedures should be designed from the "bottom up" to ensure attention to detail.

6. Management has a role in the maintenance of internal control. In fact, management sometimes is a control. Which of the following involves managerial functions as a control device?
   a. Supervision of employees
   b. Use of a policies manual
   c. Maintenance of a quality control department
   d. Internal auditing

7. Which of the following controls would be most effective in the administration of a fair and equitable compensation program?
   a. Informal policy to keep wages and salaries in line with industry averages.
   b. System of compensation based on a current job analysis.
   c. Plan to maintain a level of general compensation that is above market.
   d. System of pay increases based on length of service.

8. Which of the following is **not** a characteristic of bureaucracy?
   a. Clear hierarchy of authority
   b. Impersonal application of rules
   c. Promotion based on merit or seniority
   d. Quick response to environmental changes
   e. Reliance on rules, policies, and procedures

9. Decisions regarding assignment of employees to specific jobs on an assembly line rest with which level of management?
   a. Low-level management, such as the first-line supervisor
   b. Middle management, such as the department manager
   c. Administrative management (support) such as the personnel director
   d. Upper-level management, such as the vice president of production

10. Which of the following best explains the concept of responsibility in organizations?
    a. Responsibility may be delegated to subordinates if the manager does not have the technical expertise for the task
    b. Responsibility should be concentrated in the lower levels of the organization
    c. Responsibility is created when one accepts an assignment and is given authority to carry it out
    d. The amount of responsibility a manager has is directly proportional to the number of subordinates reporting to that manager

11. Management is commonly conceived of as performing all of the following except:
    a. Establishing the economic climate in which the business will operate
    b. Developing strategies and goals of the business
    c. Setting performance standards
    d. Organizing tasks into homogeneous groups

12. Certain activities involved in management of human resources are listed below. Which is **least** important?
    a. Selecting media for attracting applicants
    b. Selecting applicants for employment
    c. Arranging for training of employees
    d. Appraising performance of employees
    e. Paying employees in recognition of their performance

13. A subordinate's acceptance of an obligation to perform a definite task is known as:
    a. Accountability
    b. Authority
    c. Responsibility
    d. Controlling
    e. Directing

14. Which of the following is true regarding the manner in which managerial activities vary according to a person's level within the organizational hierarchy?
    a. Top managers spend substantially more time on human relations than do first-line supervisors
    b. Middle managers spend more time developing policy than top managers and first-line supervisors
    c. First-line supervisors spend more time planning than top managers
    d. Top managers spend more time directing than first-line supervisors
    e. Top managers spend more time planning than first-line supervisors

15. Which of the following is the primary reason for preparing an organization chart? To indicate:
    a. Channels of communication in the organization
    b. How departments are tied together along principal lines of authority
    c. Significant formal and informal authority relationships
    d. Functional status of various positions

16. Organization charts usually show:
    a. Amount of authority and responsibility of supervisory personnel
    b. Communication channels
    c. Levels of management in successive layers
    d. The informal organization
    e. All of the above

17. Which of the following does not promote effective leadership?
    a. Acceptance of leadership by subordinates
    b. A leader's sensitivity to situational variable
    c. A belief that all people are motivated by the same goals
    d. A good balance between employee and task orientations
    e. Position power of the leader

18. What is the primary function of a job description?
    a. Set relative job rankings and determine appropriate pay ranges
    b. Set forth desired traits of the person to do the job
    c. Define duties and results expected of the person in the job
    d. Redesign existing jobs and identify employees to fill those jobs

19. Which of the following represents data contained in a job description?
    a. Amount of supervision you are to provide or receive
    b. Amount of experience required for the job
    c. Quotas to be met within the position
    d. Amount of initiative the position requires of the employee

20. A position specification and job description should **not** include the:
    a. Reporting relationships involved
    b. Characteristics of the job to be performed
    c. Specific duties of the incumbent
    d. Instructions on how to perform particular tasks

21. Policies are intended to:
    a. Define criteria for decision making without explicitly making the decisions
    b. Define how work is to be accomplished
    c. Leave no room for personal interpretation
    d. Establish specific criteria for measuring performance

22. Coordination for frequently recurring routine matters is best achieved by establishing:
    a. Designated liaison personnel
    b. Ad hoc committee
    c. Form
    d. Procedure
    e. Rule

23. An organization's management perceives the need to make significant changes. Which of the following factors is management **least** likely to be able to change?
    a. The organization's members
    b. The organization's structure
    c. The organization's environment
    d. The organization's technology

24. Element(s) of control self-assessment include which of the following?
    I   Treating participating employees as process owners
    II   Taking survey of employees regarding risks and controls
    III Interviewing employees separately in the field
    a. I only
    b. II only
    c. II and III only
    d. I, II, and III

25. Which of the following are reasons to involve employees in the control self-assessment process?
    I.   Employees become more motivated to do their jobs right
    II. Employees are objective about their jobs
    III. Employees can provide an independent assessment of internal controls
    IV. Managers want feedback from their employees
    a. I and II
    b. III and IV
    c. I and IV
    d. II and IV